Office of Thrift Supervision
Department of the Treasury

Timothy T. Ward
Deputy Director, Examinations, Supervision, and Consumer Protection

1700 G Street, N.W., Washington, DC 20552 • (202) 906-5666

February 26, 2009

MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Timothy T. Ward Timothy T Ward

SUBJECT: *Recognition of Capital Contributions in the Form of Cash or Notes*

On January 23, 2009, OTS issued guidance to the examiner and supervisory staff reminding them of the appropriate regulatory reporting and regulatory capital treatment by savings associations for equity capital contributions in the form of cash or notes. It is equally important that OTS-regulated institutions understand the correct and accurate methodology to be used in reporting these types of contributions on the Thrift Financial Report. Accordingly, the text of the guidance issued to OTS staff is attached for your information and reference.

If you have any questions about this or other matters, please do not hesitate to contact your OTS Regional office.

Attachment

OTS Guidance to Examination Staff

January 23, 2009

Purpose

The purpose of this bulletin is to remind examiners and other supervisory staff of the appropriate regulatory reporting and regulatory capital treatment by savings institutions (institutions) for equity capital contributions in the form of cash or notes. The capital contribution may be a sale of equity stock or a contribution to paid-in-capital. These transactions are referred to throughout this bulletin as capital contributions. This bulletin does not address any other contributions of capital.[1]

Summary

Capital contributions of cash or notes may be included in regulatory capital only when the contribution is properly reported as equity under generally accepted accounting principles (GAAP) and complies with regulatory reporting guidance. Capital contributions in the form of cash are appropriately recognized as regulatory capital when received. Capital contributions in the form of a note receivable, executed prior to period-end[2], increase regulatory capital for that period-end only when the note is collected prior to issuance of the financial statements (including regulatory reports) for the same period.

Background

Many institutions' capital positions have been adversely affected by recent economic conditions. As a result, institutions and their holding companies are implementing various courses of action to increase capital. Consequently, the role of capital planning has taken on greater importance. A common source of capital for a subsidiary institution is a capital contribution from its parent holding company.

A majority of institutions are in corporate structures that include parent holding companies. The OTS expects these holding companies to be a source of financial strength to their subsidiary institutions. There are many circumstances under which a holding company may make capital contributions to a subsidiary institution. The most common reasons include when an institution needs capital for asset growth and, more importantly for supervisors, when an institution's safety and soundness is affected by declining capital.

An institution's capital may drop precipitously under adverse economic conditions due to a multitude of factors which may occur rapidly and simultaneously. Certain factors that cause a decline in capital are often not measured until after the reporting period-end date. Examples of these may include evaluations of the appropriateness of the allowance for loan and lease losses, determinations of fair value estimates, and impairment assessments. These evaluations entail substantial judgment and sometimes require time after period-end to gather necessary supporting market or other data. Additionally, examination findings, audit or review adjustments, or other subsequent events occurring after period-end can result in additional losses, or other declines in GAAP equity, that must be recorded as of

[1] This bulletin does not address, for example, nonmonetary contributions of capital (such as a building), nor items reported as GAAP liabilities but which may be included in regulatory capital (such as redeemable preferred stock or subordinated debt).

[2] Period-end refers to the balance sheet date of the quarterly or annual financial reporting period in question.

period-end. This can lead to post period-end adjustments that are recorded as of period end.

A capital contribution made after period-end to offset these adjustments would be properly included in the subsequent reporting period. The result can be that the institution reports lower GAAP equity/regulatory capital, including PCA category (for example, adequately capitalized instead of well capitalized), for the period in question. With proper capital planning and monitoring, management can increase the likelihood of remaining well-capitalized.

Proper Recording of Capital Contributions

Financial institutions are required to follow GAAP for regulatory financial reports. Regulatory capital rules do not specify a treatment different from GAAP for capital contributions; therefore, capital contributions increase regulatory capital only when such contributions also appropriately increase GAAP equity and comply with regulatory reporting guidance. The treatment of a contribution of cash and a contribution of a note are discussed below.

Contribution of Cash: A contribution of cash is recorded in the financial statements when it is received. Therefore, a contribution of cash prior to period-end is reported as an increase to GAAP equity/regulatory capital in that period's financial reports. Contributions of cash after period-end are **not** reflected in GAAP equity or regulatory capital of an earlier period.

Contribution of a Note: If a holding company intends to make a capital contribution to a subsidiary institution during a reporting period but needs a short amount of time to obtain the cash, the holding company may issue, on or before the last day of the reporting period, a short-term note payable to the institution. The institution would record the settlement of the note for cash when the cash is actually received. If the note is collected in cash prior to issuance of the financial statements, the institution may report the note receivable as an asset with a corresponding increase to GAAP equity/regulatory capital. Otherwise, the unpaid note receivable is reported as a reduction of GAAP equity (a contra-equity account) which offsets the corresponding credit to capital, and thus there would be no net increase in regulatory capital. Contribution of a note may only increase GAAP equity and regulatory capital reported in the Thrift Financial Report (TFR) if it satisfies both the existence and reporting criteria below.

Existence: For a note receivable to be properly reported in the TFR, it must meet the GAAP definition of an asset as of the reporting period-end. The receivable must meet **all** of the following criteria:

1. Evidenced by written documentation that the note was contributed prior to period-end by those with authority to make such capital contributions on behalf of the holding company (e.g., Board of Directors, CEO, or CFO);

2. A legally binding obligation to fund a specified amount by a specified date; and

3. Executed and enforceable prior to the end of the period.

While a general intent or a capital maintenance agreement that calls for the holding company to maintain its subsidiary institution at a particular capital level is an important supervisory consideration in evaluating safety and soundness, it alone would not constitute evidence that a note receivable existed at period-end that would be includable as GAAP equity or regulatory capital.

Reporting: The GAAP literature relevant to reporting notes received as a capital contribution includes:

- EITF Issue No. 85-1 (EITF 85-1), Classifying Notes Received for Capital Stock, and
- SEC Staff Accounting Bulletin No. 107 (Topic 4E: *Receivables from Sale of Stock*).

EITF 85-1 and SEC Topic 4E address whether a note received (debit) as a contribution to equity (credit) should be reported as either (1) a reduction in equity (a contra-equity account), or (2) an asset. For a capital contribution to increase equity capital, the note would have to qualify to be reported as an asset. In EITF 85-1, the Task Force explains the SEC's view[3] is that "such notes may be recorded as an asset if collected in cash prior to issuance of the financial statements." SEC Topic 4E states: "The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to publication of the financial statements and the payment date is stated in a note to the financial statements."[4]

For regulatory reporting, OTS requires all institutions to follow the SEC guidance of collection in cash prior to issuance of the financial statements. Questions have arisen about how to interpret "prior to issuance of the financial statement"[5] for regulatory reporting/capital purposes. The OTS's regulatory reporting interpretation is that the cash must be received by the institution no later than the earliest date below:

1. The TFR filing deadline (30 days following the end of the reporting period);
2. Any other public financial statement filing deadline to which the institution or holding company is subject; or
3. Actual issuance of public financial statements, including filing the TFR or a public securities filing.

<u>Caution</u>: It is inappropriate for a subsidiary institution to record an increase in regulatory capital for contributions received after period-end by reporting an asset (cash or note receivable) that did not exist as of the period-end date. A capital contribution made after period-end may not be backdated for balance sheet reporting purposes as if it was received by the institution in the prior period. This applies even if the holding company has the cash on hand (including on deposit with the subsidiary institution) and would have made a capital contribution prior to period-end had it known about a capital deficiency.

---

[3] EITF 85-1 also discusses the limited cases in which nonpublic companies reported notes receivable as an asset. Specifically, it lists examples of such treatment when the note: (1) was secured by irrevocable letters of credit or other liquid collateral or discountable at a bank and (2) included a stated maturity in a reasonably short period of time. For regulatory reporting, OTS requires all savings institutions to follow the SEC guidance of collection in cash prior to issuance of the financial statements.

[4] SEC Topic 4E also states: "It should be noted generally that all amounts receivable from officers and directors resulting from sale of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity."

[5] See EITF Topic D-86, *Issuance of Financial Statements*, for the SEC staff's interpretation of when financial statements are considered to have been issued.